

CHAPTER 3

Basic Financial Concepts

Chapter Objectives

- **Appreciate all the various expenses that affect a sport enterprise.**
- **Distinguish between revenue and expenses.**
- **Describe the difference between finance, economics, and accounting.**
- **Identify the elements of the three primary financial statements: balance sheets, income statements, and cash flow statements.**

(continued)

Chapter Objectives *(continued)*

- **Define the common financial ratio used to assess an organization's liquidity, activity, and profitability.**
- **Understand the concept of time value of money.**
- **Understand the concept of future value, including its calculation for a single amount of cash received today.**
- **Understand the concepts of present and future value.**
- **Calculate the present value of annuities.**

Key Terms

- **Revenue**—Money coming into a sports business (e.g., ticket sales, broadcast contracts, concession sales, or sponsorship agreements).
- **Expenses**—Costs that are incurred (e.g., player salaries, equipment, travel, executive salaries, and other expenses ranging from rent to insurance premiums).
- **Credit**—Money owed to the business.
- **Debt**—Money owed by the business to others, such as suppliers.

Art of Accounting

- **Two forms of accounting**
 - **Financial**
 - Recording, summarizing, and reporting financial transactions of organization to create financial statements (income statement, balance sheet, and cash flow statements)
 - Outward focus
 - **Managerial**
 - Using financial statements to make managerial decisions about organization
 - Inward focus
- **Accounting produces numbers for components of the business that are quantifiable.**
 - Never any guarantee that numbers relied on are correct

Audited Financial Statements

- **Auditors**
 - Use standards to report on the accuracy and correctness of accounting approaches to producing financial statements in a systematic manner.
 - Auditor is independent from the company's management.
 - Financial statements were audited.
 - Financial statements are management's responsibility.
- **Sarbanes-Oxley Act (2002): Executives of a publicly traded company certify financial statements and face criminal punishment and fines if incorrect.**

(continued)

Audited Financial Statement *(continued)*

- **Auditor's opinion addresses:**
 - Fairness of financial statements
 - Degree to which statements comply with GAAP guidelines
 - Noticeable changes in accounting principles from industry norms
- **Auditor opinion can be:**
 - Unqualified opinion (statements are accurate)
 - Qualified opinion
 - Adverse opinion (statements do not conform with required principles)
 - Disclaimer (auditor was unable to complete report because certain data were not provided)

Types of Financial Statements

- **Three primary statements**
 - Balance sheet
 - Income statement
 - Statement of cash flows
- **Statements provide information about business in a consistent manner as results of generally accepted accounting principles (GAAP)**

(continued)

Types of Financial Statements *(continued)*

- **GAAP guidelines determined by**
 - American Institute of Certified Public Accountants (AICPA)
 - Financial Accounting Standards Board (FASB)
 - Securities and Exchange Commission (SEC)
- **Balance sheet—Financial position of a business at a single point in time, offering information about assets, liabilities, and owner's equity**

(continued)

Types of Financial Statements *(continued)*

- **Assets = liabilities + owner's equity**
 - Assets (debit side)—what company owns
 - Liabilities and equity (credit side)—how were assets financed
- **Assets are listed according to liquidity or quickness to convert to cash**
 - Current assets—converted within one year or less
 - Fixed assets—least liquid; plant, property, and equipment
- **Liabilities are listed in the order they must be paid with current liabilities being obligations required to be paid in one year or less.**

(continued)

Types of Financial Statements *(continued)*

- **Equity is the portion of investor money in the company through purchasing stock or reinvesting income not distributed to shareholders (retained earnings).**
- **Income statement—Business's profit or loss over a given length of time (e.g., month, quarter, year) as well as operating performance over that period between two balance sheets**
- **Income = revenues – expenses**

(continued)

Types of Financial Statements *(continued)*

- **Three sections**
 - **Operation**—Revenues and expenses from current operations
 - **Non-operation**—Income and expenses of earned income from financial investments
 - **Net income**
- **GAAP**—Accrual-based accounting
 - Revenue is generated when exchanged for goods or services and reported.
- **Depreciation**—Estimation of cost of equipment and property that is used up in process of producing and distributing goods and services (not a cash outlay)

(continued)

Types of Financial Statements *(continued)*

- **Statement of cash flows—Cash position of a business has changed over a given period from operations, investing, and financing activities**
 - **Operation—Cash flows related to sale of goods**
 - **Investing—Additions or sale to fixed assets for company**
 - **Financing—Cash flows to and from creditors and owners**
- **Reports the difference between what a company brings in and what they pay out**
- **Indirect method commonly used**
 - **Net income + noncash expenses – noncash revenues**

Financial Ratios

- **Aid in the evaluation of financial statement information to provide insight into the condition of a business**
- **Five main areas**
 - **Liquidity—Organization able to meet short-term financial obligations**
 - **Activity—How effectively a firm manages its assets**
 - **Financial leverage—Extent to which an organization relies on loans rather than equity for financing**
 - **Profitability—Ability to generate profits from sale of goods and services**
 - **Firm valuations—Value of an organization**

(continued)

Financial Ratios *(continued)*

- **Serve as a barometer against benchmarks**
 - Previous company ratios
 - Competitors' ratios
 - Ratios of other firms of similar size and scope

Time Value of Money

- **Concept that money in today's dollars decrease in value the further out into the future it is expected to be received**
 - **“A dollar received today is worth more than a dollar in the future.”**
- **Factors for TVM**
 - **Future value—Value of an initial lump sum of money after it is invested over one or more periods**
 - **Present value—The value of any future value today when discounted over multiple periods**
 - **Number of periods—Length of time money is invested**
 - **Interest or discount rate—Percentage return that can be earned on an initial amount of money**

(continued)

Time Value of Money *(continued)*

- **Compounding**—Process of holding stock and accruing a further return over multiple periods
- **Compound interest**—Each payment of interest from the period that is reinvested to earn a return as well

Time Value of Money: Future Valuation

- **Future value = $C_0 \times (1 + r)^t$**
 - **FV = future value**
 - **C_0 = initial amount of cash that is invested today**
 - **r = interest rate or rate of return**
 - **t = number of years over which the cash is invested**

Future Valuation Example

- **What will the value of \$1,000 received today be in 5 years if we assume an interest rate of 5%?**
 - **$FV = 1,000 \times (1 + .05)^5$**
 - **$FV = \$1,276.30$**

Time Value of Money: Present Valuation

- Present value calculation is done by a process known as discounting.
 - Future value is discounted by the discount factor $(1 + r)^t$
- $PV = C_t / (1 + r)^t = C_t \times PVF_{r,t}$
 - PV = present value
 - C_t = cash flow received at the end of t periods
 - r = annual return of interest
 - $PVF_{r,t}$ = the appropriate present value factor for \$1 received t periods into the future

Present Value Example

- What is the present value of receiving \$1,000 in 10 years at a 4% interest rate?
 - $PV = \$1,000 / (1 + .04)^{10}$
 - $PV = \$675.56$

Time Value of Money: Annuities

- **Annuity**—Constant stream of payments that is received for a fix number of periods
- **Common things**—mortgages, student loans, and pensions—are examples.
- **$PV = C\{1 - [1 / (1 + r)^n]\} / r$**
 - PV = present value of annuity
 - C = constant cash flow per period
 - r = annual rate of return
 - n = number of periods during which the cash flow will be received

Annuity Present Valuation

- What is the present value of receiving \$1,000 per year for the next 5 years if we assume a discount rate of 6%?
 - $PV = C\{1 - [1 / (1 + .06)^5]\} / .06$
 - $PV = \$4,212.36$

Economic vs. Financial Analysis

- **Economics**—Study of social, governmental, and numerous other factors that influence financial state of industries
- **Elasticity of demand**—Degree to which change in pricing affects the unit sales of a product
 - **Inelastic**—Price change doesn't affect demand
 - **Elastic**—Price changes affected by demand
- **Economic impact is important.**
 - **Example:** Public funding of sports facilities
 - **Advocates**—Increased economic activity associated with the facility
 - **Opponents**—Private owners are gaining benefit from public fund

Class Discussion Topics

- 1. What is the difference between accounting and finance?**
- 2. Why is understanding sport economics important for someone working in sport finance?**
- 3. Briefly explain the difference between a balance sheet, cash flow statement, and income statement.**
- 4. What happens to the present value of an annuity if the discount rate is increased? What happens to the future value if the discount rate is increased?'**

(continued)

Class Discussion Topics *(continued)*

- 5. If we assume an interest rate of 5%, would you rather have \$1,000 today or receive \$1,120 in 3 years?**
- 6. Assume that two athletes sign 10-year contracts that pay out a total of \$100 million over the life of the contracts. One contract will pay the \$100 million in equal installments over the 10 years. The other contract will pay the \$100 million in installments which increase 5% per year. Which athlete received the better deal?**